

***The Private Annuity Trust- “A Way Out”
by Gordon Corwin and Chris Armes***

Before you sell your property, it is wise to know your options to avoid the necessity of doing an IRA 1031 exchange and thereby creating unwanted tax consequences plus continued landlord/owner responsibilities. So here is a **“way around capital gains tax”** via a flexible and IRS accepted program known as the Private Annuity Trust.

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will earn much more money than
he would if he/she sold the
property and paid the tax up-front.***

Those of us who own highly appreciated assets like homes, commercial real estate, stock portfolio's or businesses, are often reluctant to sell that asset because of the capital gains tax and depreciation recapture costs associated with the sale.

How many times have you heard these comments?

- ***“I am going to get killed with capital gains taxes when I sell my property.”***
- ***“Because of the capital gains taxes, we are not going to sell our property.”***
- ***“I’m getting older and want to start enjoying some of the equity I have earned over the years from my investment property, but I don’t want the government taking 25% of my hard work. There has got to be a better way.”***

Sound too familiar? Well, welcome to reality. These are the questions we hear daily that plague the minds of American taxpayers. We hear it all the time. Luckily there is a **“way out”**. There is a smart, functional, and more importantly, legal way to address these issues. The answer may lay with an old estate planning tool called the ***Private Annuity Trust***.

If you or someone you know is sitting on real estate with large amounts of equity and are not listing their property in fear of “capital gains taxes”? Then you may want to consider a Private Annuity Trust, (“PAT”). The PAT is an IRS accepted program, found under (**Section 72 of the IRC**) which allows the seller of the property to defer capital gains taxes at the time of sale.

Actually, this estate planning tool has been around since the early 1950's and has been used for deferring capital gains taxes associated with a sale of highly appreciated assets like business and stock portfolios as well as real estate.

There is no maximum to the size of the transaction and the PAT can be used on any kind of real estate transaction such as your primary residence, rental properties, vacation homes, commercial properties, hotels, land, industrial complexes, retail developments, shopping strip malls and even baron land to name a few.

What are Capital Gains Taxes?

Capital gains are a tax on the profit we make when we sell assets. Any long term asset sold at a profit is subject to a capital gains tax of some rate. The rate for a significantly sized sale of an asset owned for one year or longer will be 15% for federal taxes. Most states charge 5% to 10% on top of that, making the total tax run as high as 25%. If there is depreciation recapture in the asset sale, that is taxed at 25% federal rate, possibly making the tax on recapture higher than the capital gains tax.

That isn't the end of the story for the total tax effect though. Capital gains must be added to the taxpayer's adjusted gross income (AGI). This means that capital gains or profits will raise the “floor” above which one can take a number of itemized deductions.

This often results in a large decrease or total loss of those deductions. This makes the effective, but hidden capital gains rate much larger than the stated federal and state rates. ***To make matters worse the capital gains and depreciation recapture taxes must be paid within ninety days of the sale of the asset.***

This is where the Private Annuity Trust comes in. The process starts with a property owner, (also referred to further as the annuitant), transferring ownership of the property to a dedicated family trust (The Private Annuity Trust).

In our example (found on the following page), we will assume the asset is worth \$1,000,000. The transfer isn't a gift, but a special type of sale. The owners of the trust are the heirs of the property owner, probably his children.

Next, the trust “pays” the property owner for the property. The payment isn’t in cash, but with a special payment contract called a “private annuity”. It is strictly a private arrangement between the trust and the annuitant. The form of payment is a life annuity.

A private annuity is something like an installment sale. Instead of specifying an exact number of payments as in an installment sale, the private annuity promises to make payments to the annuitant for the rest of his life. Since the property in our example is worth \$1,000,000, the face value of the annuity contract is also \$1,000,000.

The annuity payments may begin immediately or they may be deferred for some period of months or years. The trust then sells the property. There are zero taxes to the Trust on the sale since the Trust “purchased” the property in the form of a private annuity contract of \$1,000,000 and then sold it for cash at \$1,000,000.

The property owner is not taxed on the sale since he has not yet received any cash for the sale. Often annuitants will choose deferral because they have other income and don’t need the payments right away. Of course, annuity payments may begin immediately.

Deferral is strictly an option. It is important to understand that payment of the capital gains tax to the IRS is done with an “easy installment plan”. **There is no interest or penalty on these deferred payments of the tax.**

On top of that the tax payments will be made with depreciated dollars. The tax dollars will be worth far less than they are today due to inflation. Yet the investment money in the trust will grow at greater rate than that of inflation.

In our example, the \$1,000,000 accrues interest to the annuitant. (The interest rate is dictated by the IRS under Section 7520 of the Tax Code.) So the annuitant has the entire untaxed value of the sale, \$1,000,000, growing and earning interest for him. **The property owner / annuitant will earn much more money than he would if he / she sold the property and paid the tax up-front.** This is due to the deferral and the spreading of the tax payments over an additional period. (Over the rest of the seller’s life.) Let us now examine some numbers and compare the annuity transaction to a straight taxed sale.

We start with the \$1,000,000 property value. The annuitant’s basis is \$200,000, leaving a profit of \$800,000. We are estimating combined federal and state capital gains taxes at \$160,000, which is 20% of the profit. This leaves net cash of \$840,000 in the direct sale vs. \$1,000,000 in the annuity deferral sale.

We are assuming the investment cash earns an annual percentage of 8% before income taxes for the next 20 years. The property owner is 45 and chooses to start the annuity payments at age 65. Under the direct and taxed sale, the property owner receives annual payments of \$277,300 vs. \$330,119 under the annuity plan. This yields an estimated life payout of \$6,932,500 under the taxed plan vs. \$8,253,000 with the annuity strategy.

Making these same assumptions, the balance of the investment portfolio under the direct sale would be \$5,264,000 vs. \$7,787,790 with the Private Annuity Trust strategy. **That is an advantage of \$3,844,290 more dollars too the annuitant and his family!**

It is easy to see why this strategy is rapidly becoming the strategy of choice when selling property. This advantage is due to the larger amount of net cash that was initially available to invest for the annuitant.

<u>Taxed Sale</u>		<u>Annuity Deferral</u>
Selling Price 1,000,000	----- --	1,000,000
Basis 200,000	----- --	200,000
Profit 800,000	----- --	800,000
C.G. Taxes 160,000*	----- --	Deferred
Net Investment Cash** 840,000	----- --	1,000,000**
Deferral Period 20 yr. (8% growth)	----- --	20 yr. (8% growth)
Annuitant Present Age 45	----- --	45

Annual Payout 277,300	----- --	330,119
Est. Life Payout 6,932,000	----- --	8,253,000
Balance of investment \$5,264,000		\$7,787,790
\$ 3,844,290 Advantage**		

While we have primarily focused on the capital gains tax, depreciation recapture taxes are also deferred with a private annuity. But in either a cash sale or an installment sale, the depreciation recapture is taxed immediately. While an installment sale can spread the capital gains out over a number of years, it cannot do the same with depreciation recapture.

Furthermore, installment sales have "related party" rules that prevent an arrangement such as the private annuity trust described above. The related party rule only permits an installment sale with an outsider and the Private Annuity trust can make an installment sale with a family members

There is substantial flexibility in making investments with the trust's funds. The money may be invested in securities, real estate, or even in a new or existing business.

The primary requirement of the trust's investment program is simply to produce the cash flow necessary for the private annuity payments to the annuitant.

There are significant benefits for the property which the annuitant transfers to the trust:

1. Whatever is left in the Trust at the time of the annuitant's death will pass to the beneficiaries completely free of estate and gift taxes.
2. This arrangement does not trigger any gift tax consequences no matter how much the property is worth.
3. The property will not need to go through probate when the annuitant dies.

The deferral of capital gains taxes can produce a dramatic increase of cash in your pocket. But that is far in away not the only benefit:

1. Everything from the sale proceeds and all trust earnings either goes to the annuitant or to the heirs. When the annuitant dies everything left in the trust will go to his heirs.
2. The trust can make a cash sale. It is not forced to make an installment sale to the outside buyer in order to spread out the capital gains tax. This is an advantage because you never know whether the outside buyer will make all the payments on an installment sale.
3. The private annuity is the equivalent of receiving a tax free loan from Uncle Sam.
4. The formal mechanics of the trust provide the discipline that some find helpful in providing for their own retirement.
5. The private annuity works equally well for single or married annuitants. Married couples can have the private annuity written as a joint, last to die contract.

Nothing is given away to charity as happens with the competing strategy known as a charitable remainder trust.

The Private Annuity allows all the principal and accrued interest to be paid to the property seller, whereas the charitable remainder trust pays income (interest) only. In most cases the Private Annuity yields more bottom line dollars to the property seller than the charitable remainder trust does.

As illustrated above, the Premier VI Private Annuity/Trust has the ability to generate substantially more money over the long run than a direct and taxed sale. It is also superior to the charitable remainder trust and installment sales in many respects. With the baby boomers set to retire and the need for them to have professional estate planning advice to maximize their estate and minimize the taxes, now is the perfect time to learn about this sales strategy. Below is a list of most frequently asked questions:

Q. When I sell the property and put the cash in the trust, may I keep some of the cash from the sale?

A. Yes, in that case you would pay taxes only on the portion of money which you kept for yourself outside the trust.

Q. How can I have my tax advisor or attorney analyze the private annuity idea?

A. We will gladly provide your tax advisor with the technical and legal information they need to properly advise you. For a quick answer have your CPA review; **IRS Revenue Rulings 55-119 and 69-74, plus the IRS' GCM39503 of 5/19/86 and Treasury Decision TD-8754 issued in 1998, and the Ninth Circuit U.S. Court of Appeals decision "LaFargue v. Commissioner, 689 F. 2d 845 (1982)".**

Q. I'm interested in having one of these plans put together, what should I do next?

A. It's very easy.

Your next step is to have an "illustration request form completed to see if you qualify for the plan. You can call a toll free number and request a "**free property analysis**" which will illustrate the capital gains taxes on your property or go to www.myPATplan.com/gordoncorwin. This summary is prepared by our qualified tax attorneys and can typically be sent to you within 24 hours. Once you have received the illustration summary on your property, you can then share this information with your CPA or tax attorney for further review. Readers are cautioned to consult an advisor of their own selection with respect to any particular situation.

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